Transcript Q&A

Fragile States, Capital Flight and Tax Havens

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Question 1:
This is quite a specific question for Virginia. Can you explain the link between economic reform and reduction of subsidies and those changes which might affect poorer people, and the patronage system? How does addressing one affect the other?

Ginny Hill:
It’s quite a specific response about the way power is structured in Yemen, so forgive me if you are here for a much bigger picture. Because the government hasn’t really been able to establish its control effectively, these networks of families, relationships, marriage connected. The government needed resources in order to kind of create a buy-in, create loyalty. Diesel subsidies have been a really important part of that network. Nearly a third of the state budget goes toward subsidizing diesel, and a lot of that has been given out to elite families as a kind of buy-off to keep their loyalty to the state, and the diesel is being sold off in other countries. It’s being sold off on the black market. So really a third of the Yemeni budget – some of it is actually going into diesel which is used in the country but it’s one of the resources that the president was able to use in his role of head of state to actually keep the regime together through these informal power networks and tradeoffs.

So if you start to reduce the diesel subsidy, you suddenly have much more money to play with – the state budget becomes more viable and more sustainable. But what you’re doing is you’re unpicking the patronage structure and there isn’t yet – if you’re going to renegotiate the system of power that holds the regime together in the absence of a state, you suddenly get spoilers, and there isn’t enough political capital to manage that.

So [Ali Abdullah] Saleh was having that problem anyway before the uprising. Now, since the uprising, there is even less political capital. It’s much more dispersed inside the system now. There are different centres of power; there are rival patronage systems in place now.

Then the knock-on effect for Yemenis, ordinary households, is that commodity prices go up. They’ve already exhausted a lot of their coping mechanisms because of food price rises over the past five years. Fuel prices are important for all kinds of other factors inside the commodity supply chain, because it affects water – people use diesel pumps to get water out of the ground – and food and water are transported on roads. So as soon as the price of diesel is going up, suddenly people who are already living on the
breadline are going to have an even harder time trying to survive, and it’s affecting the way the system of power is held together at the highest level.

**Ronen Palan:**

I don’t know if I can directly answer that but I’ll also try to respond to your point, which is a very interesting point, and it links to your question clearly. What Stefan is telling us is it’s really ultimately not important where the money is registered. It’s not important who owns the money. It’s important where the money is invested or where real investment takes place, and real investment is basically based on the future. If you create the conditions which capital believes there’s the future opportunity for growth, I don’t care who it is, I don’t care what the name of it, you’ll have growth. That’s the point. That’s the point about putting the primacy on governance structure and not worrying about these dynamics that Ginny is talking about.

The problem is, of course, that these particular governments and particular elites, because of their international links, don’t have an internal incentive structure to create these futures in their societies. Their own futures lie elsewhere. Their own countries are basically a source to be exploited. That’s basically the answer to you but also the answer to you. It’s a chicken-and-egg situation. I think Stefan is correct that if we try to isolate one from the other, then we’ll not get the right answer. But by saying that, Stefan, don’t try to isolate one from the other in responding to that. But I do realize that DFID will have great difficulties dealing with the structural problems created by this continent that I call offshore. Which is located in London, of course.

**Question 2:**

Stefan, you mentioned that there was perhaps not a major qualitative difference between the traditional licit ways of diverting rents overseas – buying houses in Brussels or indeed here in London – and putting it into secretive tax havens. But surely there is a difference in terms of the level of transparency and the asymmetry of information. So we could see, for example, that the increasing availability of information about foreign investments – for instance, news broadcasts about the properties that [Muammar] Gaddafi’s sons were buying in London – had a political impact back in Libya. Whereas if you’re talking about tax havens, you’re talking about things that it’s very difficult even for very eminent economists with great access to databases to actually monitor.
Stefan Dercon:

I'm addressing in a way implicitly also Ronen's point. My point is not that trying to – first of all, the point is not that I'm trying to say dealing with illicit tax havens is going to not have beneficial impacts. I'm convinced that for places like Ghana, for some of the countries that are now discovering natural resources in Africa, it is actually a really good thing. I'm just trying to make a distinction here with the extreme levels of fragility we can have in some places, that actually almost any investment abroad is better for these elites than actually leaving it there. Clearly there are some of these places where we'll have a problem.

I agree also entirely with you: there's a fundamental difference between the transparency – the Gaddafi houses are a very good example. In a way, the Mobutu [Sese Seko] houses in France were helpful in that as well in the latter stages of his regime, to actually bring this out. I actually made a slightly different point. I said that rent-seeking states are very good at organizing licit schemes as well. I'm thinking of trade policy and subsidy systems. Nigerian energy subsidies is a wonderful racket, where a lot of it is legal. The construction of monopolies in certain food processing, on imports, bans and so on – I could name the name of a very well known, one of the richest men in Africa. But ultimately, that's totally legal but built on patronage systems that can get trade benefits. These are legal forms of rent-seeking. You can invent them, it's not so difficult. I can help anyone who wants that. You can do that. It's not rocket science. So that's all I'm trying to say. The root problem needs to be addressed there as well, and the isolation.

I think on your point I would say the more we go into deep fragility, we better start on the one, because the binding constraint is on the political economy where we are for lots of other countries – these are really positive things. DFID not have an appetite? We have an appetite for anything. Do we have the power, is another matter.

Question 3:

To what extent, if any, does the problem of bribery and corruption in some of these countries get discussed at a level of capital flight – at the government level, when they're trying to work out the way forward?
Stefan Dercon:
Could you clarify – do you mean at the level of negotiations, discussions? Or when they make their decisions?

Question 3:
Is it a problem, for example, that's left to the Yemenis to solve? For example, bribery. Or are we also tackling that debate at the same time as thinking about tax havens and why capital flight might either legally or illegally be happening?

Stefan Dercon:
I won't give you a complete answer, I think here, partly because I'm not aware of every single thing – the kind of way that we would work in every single country in dealing with this. First of all, as the UK, we have the UK Bribery Act. As an instrument, it is something that actually resonates quite strongly. We do know in the countries we work in, the fragile places, this is a binding constraint for quite a lot of business. This is a high-level game because you risk these countries not getting reasonably transparent investments where there's little worry – was it really 100 per cent transparent or not? So you risk actually not getting productive investments because firms might get a little risk-averse doing it, thinking it will maybe look like one even if it isn't, if you see what I mean. So the grey area is there. So it's a binding thing.

On the other hand, in terms of the entire discussion, I think one mistake that we would try to avoid is that in dealing with a country, whether we are there especially in the context of aid, to actually consider bribery and corruption as causes rather than symptoms of fundamental structures and malaise. So they are being raised and I would say sometimes we better see them in the context of an entire system of political incentives in a place rather than in isolation, because they may sometimes be symptoms of something, not necessarily the fundamental causes.

But it’s a very difficult balance. As DFID, we have zero tolerance for anything that has to do with bribes or corruption that we see. Unfortunately the world is a little bit like – it affects risk-taking for us as well, because you have to be careful with certain things that you can get involved in. But yeah, there is this thing.

But I think the bigger point is seeing it as the general incentives and let’s be careful not to take it in isolation. That would be constructive.
Ronen Palan:

I would like to say something about bribery and maybe, John, you as well would like to say about it. Obviously bribery is a big issue and it’s an issue that we can all empathize with. It’s the one that we associate particularly, of course, with developing countries. But actually all the evidence suggests that bribery is a small portion of the problem of capital flight that these countries experience. In that sense, I don’t want to underestimate, I don’t want to play down the importance of bribery – it does create a sense of dislocation and a general sense of injustice among people. But in terms of the figure overall, according to Raymond Baker – and John, you’ll tell me if you still believe in these figures – only about five per cent of capital flight from developing countries is actually due to bribery. The big figures are what we call transfer pricing, companies’ transfer pricing. It’s more difficult to get upset with those, to shout, ‘Transfer pricing!’ It’s much easier to identify a particular tyrant who seems to be buying things on eBay when people around him are dying.

But in a sense, we are missing the picture here. The picture is largely transfer pricing by large companies operating in many of these countries. Secondly, officials – the issue of governance – and only thirdly, I think, bribery.

John Christensen:

Ronen mentioned Raymond Baker and his work on this. Raymond published a book precisely on this subject in 2005, called Capitalism’s Achilles Heel. To give you some idea of the magnitudes: corruption, in the narrow sense of bribery, only accounts for about five per cent of the illicit flows (he talks in terms of illicit financial flows rather than capital flight). Thirty-five per cent is accounted for by criminal embezzlement, fraud and similar activities – which are particularly pronounced in places like Yemen. I’m not a Yemen specialist but I did specialize in Algeria and Libya, and there was massive embezzlement amongst officials and so on. Thirty-five per cent of the global flows. Trade mispricing, including transfer pricing, accounts for 60 per cent. So that is the big fish and that’s where the global rules have completely failed.

My own take on corruption is that we’ve tended to focus far too much on the demand side, on the public officials at borders and so on asking for brown envelopes. We haven’t focused sufficiently on the supply side, by which I’m talking about the high-level banks, the high-level law firms, the accounting firms, the big businesses who are very actively engaged in helping shift these billions out of sub-Saharan Africa and out of the Middle East. It takes a massive infrastructure. In my own case, I’ve spent many years investigating
this from the inside. I went to Jersey to look at how tax havens facilitate these flows. At a very practical level, I, as an economist – and this has very much shaped my career – realized that contrary to economic theory, you have British banks, you have British accounting firms, British law firms, very actively promoting and marketing capital flight services in all of these countries, particularly the rent-seeking, petrodollar, hydrocarbon economies. That, I think, is where Britain can play a very significant role in curtailing that, by cracking down on our own part in this.

**Ginny Hill:**

The reason I ended up working on this report with my colleagues is I’ve been working in Yemen for seven years and I was trying to understand why the elite was behaving the way it was, because it doesn’t look at all logical. You’re looking at Yemen and you’re looking at the way the elite behaves in Yemen – it seems like a really self-defeating form of behaviour. But once you put this analysis into the mix, it makes sense.

So the thing we’re calling for in the report is more research to look at specific patterns of capital flight out of Yemen. Obviously there are hazards around that and there’s lots of obstacles. I agree entirely that a lot of the money is ending up in luxury hotels in Europe. It doesn’t have to be going into tax havens. But I would suggest that at least a large percentage of it is passing through tax havens at some stage, and that’s part of the process of protecting it so that it can’t then be seized.

The reason I feel that 2011 was such an important year is because it gave us an example to see – it was an experiment in elite behaviour. For the first time their assets were potentially threatened by the prospect of sanctions at the UN Security Council, and it actually had an impact on their behaviour. They stopped fighting. So I feel like it’s a perfect – it matches all the literature about elite behaviour in fragile states and incentives for fraud. So this is another element in the mix that has led me further down the line of this analysis. I agree entirely, not all of this money is ending up in tax havens or passing through it, but tax havens themselves are part of the system. The Yemeni elite has been able to take advantage of that system, the change to the global financial environment since the end of the Cold War. What we’ve done in this report is – it’s a political economy analysis that takes you right back to the 1960s and looks at the way the market in Yemen and the state – the relationship between the market and the state has evolved since the 1960s.
You can’t understand that in isolation. You have to look at it in the context of international changes.

**John Christensen:**

I have to abuse my prerogative as chairman and say I’m a little bit concerned about the way you talk about tax havens here. It’s easy to think of tax havens as small islands or somewhere up in the Alps, Lichtenstein and so on. We’re sitting in one of the world’s largest tax havens here in London. The United States is also a huge tax haven – Delaware, Nevada, Wyoming are all tax haven states, if you follow the Tax Justice Network’s (TJN) definition. Yes, the money is flowing through the small islands but largely ending up here and in Switzerland and in Belgium – which is another tax haven according to TJN – and in the United States.

**Question 4:**

I just wanted to ask if you could comment – all of you, not just Professor Dercon – on the very ambitious president’s commitment endorsing the work of the OECD. That’s the 15-point action plan on BEPS (Base Erosion and Profit Shifting), so tax transparency and the beneficial ownership piece, the commitment to have automatic exchange of information as a global standard. And more specifically, has anybody actually looked at the level of investment to operationalize this in fragile states such as Yemen? Are they going to be using some of the – or divesting or diverting – some of the development budgets from things like providing food and health care to setting up technology platforms to allow this to happen?

**Ronen Palan:**

About automatic exchange agreements, clearly a step forward. I’ve been following this world of offshore for the last 15 years or so – I don’t know why I started but there you go. I think that in the last five years there have been more changes than in the last hundred years. Something very positive is taking place – Stefan, I agree with you about that. Still, the numbers don’t budge. Overall the figures, the data about the size of that particular world, don’t budge. We don’t know why but perhaps Stefan can help us here. Automatic exchange agreements would be very difficult to implement but they are the right direction.
About BEPS, we had a conference at City a few months ago, in July, and we looked at it very carefully. John, you are much more articulate than me, maybe you can summarize the conclusions we reached. We were not too impressed, were we?

**John Christensen:**

We damn with faint praise. BEPS – the Base Erosion and Profit Shifting – the very fact that the OECD finally came forward, fessed up and said yes, there is a problem with base erosion and profit shifting, after many years of denial, after many years of dismissing all the case-studies as rotten apples – they said suddenly, okay, they’re all rotten. And the reason they’re rotten is because the rules are wrong and we need to reform the rules. Well, good. When they came forward with their action plan two weeks after our programme at City, we thought: yes, if they can achieve the 15-point action plan that they’re outlining, we will see an astonishing step forward. Not necessarily the step forward that we at Tax Justice Network would like to see – because we’d like to see a complete reform of the system for taxing multinational companies – but if they can achieve what they’re proposing, we will see the most astonishing reform we’ve seen in the last 50 years. This is where the League of Nations stumbled, on the economic side.

I actually had this kind of moment – for those of you familiar with the film *Love Actually* – when the prime minister of Britain in that film finally says something right. Here we had David Cameron, the British prime minister, saying something right. We all cheered and thought: great, he’s using the G8 to put forward some really profound proposals, and it was astonishing. Like you, I was delighted.

Automatic information exchange as the global standard – 10 years ago, OECD said to me: it won’t happen in your lifetime so don’t even bother. Even three years ago they were saying the same. So this is a very impressive step forward and I’m delighted that the British prime minister pushed it through the G8.

Also country-by-country reporting, a standard that was worked up within Tax Justice Network by a chartered accountant called Richard Murphy. Now already built into the Dodd–Frank Act and coming forward in the European Union. Astonishing progress and great to have the prime minister putting himself behind this.
But the one reservation we have is those 15 points will be extraordinarily difficult to get an international consensus on. There are many countries – not least the United States and Canada – that have an interest in blocking many of the key proposals. So it’s going to be a very hard slog to get these proposals through. Nonetheless, it’s very welcome that finally these issues are on the agenda.

I’d also like to repeat that for us it’s a welcome step that China just two weeks ago signed up to automatic information exchange, because even six months ago their senior negotiator at the United Nations was telling me he didn’t think it would ever happen. So we’re making progress on many fronts.

Stefan Dercon:

I’ll just add to it – you did my job just now so that’s absolutely delightful. But there is a concrete thing that you mentioned and I wanted to make a comment on that, when you said, will we switch the resources into this to make this happen? One thing I definitely have learned being inside the development ministry and not outside is that money can’t buy you everything. It’s a really important thing here that working on – as already said, it is at levels first of all getting the deal brokered, and what ought to be something of this kind of global standard – good bedfellows to have involved in and so on, to get Canada and other countries on board. That’s already some kind of work. What we can do as DFID and what we are looking for ways of doing – and I can’t say step by step very concretely, I would not have the information – but I do know that we are entrusted to actually try, on the developing country side, to get some of these agendas realized. That’s what our role is.

The point is, with many of these things – working on things that are fundamentally about governance structures in these countries, that is not an issue of just spending money. There is an awful lot of work that is being done on governance like, oh let’s build up the institutions like they exactly look in other countries and we just plant them. They have not necessarily any bite. There is a nice metaphor that some people use these days to talk about institutional reform in developing countries – it’s a bit like isomorphic mimicry, which is basically the following: if you go in nature and look at frogs, you will, in tropical forests, find lots of frogs that look like poisonous frogs but they are not poisonous. So we have a tendency of building up all the rules’ networks, the regulation networks, even the enforcement agency and all the things in these countries, but if we don’t think about what is the incentive to make them
function in the end, it won’t work. So we get a lot of frogs that don’t have any poison in them.

So this is a real problem in working with governance. Working on these kinds of issues is a bit like guerrilla warfare: pick your targets, know that there will be flaws and you will have to retreat sometimes, get your incentives right. You won’t be able to occupy all territories and really work very carefully in these countries.

So money will be put in it but it’s not about just money. We need to find windows of opportunities, the right places, get the incentives right. Otherwise this is just a waste of money. A big capacity-building programme across all developing countries for this is probably not what we should be doing.

**Ronen Palan:**

I would like to say something about the happy – you know, that we all come in agreement. I’ve just been recently invited to the Tax Planning Association – they had a nice meeting, of course, in Monaco. It was lovely. They are a pluralistic lot and they wanted somebody like myself to explain why some people are against tax havens, because they don’t understand that. After I gave my spiel – to a very dubious crowd – then a gentleman, actually from one of the biggest companies, large legal companies, basically stood up and gave a very interesting talk about whether to use Britain to run your businesses.

His argument was, yes, Britain is still an excellent place for registration for two reasons. One is, people don’t think of Britain as a tax haven, so it’s a very good place for tax planning. Secondly, since the new government came to power they have strengthened various rules and regulations that make it much easier to use Britain as a tax haven. This is a different arm of government, nothing to do with you guys and probably don’t talk to you and hate you and dislike you.

**John Christensen:**

Ginny is going to have the last word as I was very strongly instructed to finish at exactly seven o’clock. I’m going to, in rounding up, put in a plea: according to the OECD Development Administration Committee, less than one per cent of all overseas development assistance goes into strengthening tax regimes. When you talk to the OECD they say the best kind of aid is spelt T-A-X. That’s the way in which we’re going to help developing countries exit from aid
dependence. Let’s have a plea for more assistance into better tax systems and for the Oxfams of this world to do a great deal more at grassroots level to build up public awareness of the importance of tax and why tax is the best way of overcoming, in the case of Yemen, this huge gap between the tiny elites that are rent-seeking and the completely disenfranchised majority.

**Stefan Dercon:**
Knowing you’re going to close, may I briefly say a few things we do? Because actually, you say the plea to do it – I would repeat the percentage is not the key thing here. What you do is more important.

**John Christensen:**
Up to a point.

**Stefan Dercon:**
Up to a point. But it’s a really interesting thing where more and more, and also within the department – and actually our secretary of state has been quite helpful in this respect, of encouraging us to think about every country we work in – to think about how can we get out of this country. What is actually the transition strategy where taxation and getting actually the self-financing ability of these countries is our objective? Our objective becomes defined as getting a self-financed, secure exit from poverty. That’s what we’re actually aiming for. Working with HMRC is another thing they are doing, which actually in some countries – and I think in Tanzania they’re working – is actually kind of remarkably successful – that we can actually do things. So we listen to your plea and we will do more in coming years.

**John Christensen:**
Great, I’m going to Dar es Salaam on Saturday. I’ll test on that one. Last word.

**Ginny Hill:**
The report was really written as a case-study not just for this question of fragile states and tax but also for the political economy of the Arab Spring. The question around taxation is also a discussion that’s going on between the
government and the electorate here as well – this idea of tax as the crux of the social contract. We’ve just done a very detailed case-study of that here in the context of the global discussion about that question.

I wanted to just say that DFID in Yemen really has been out in front for several years, really since the mid-2000s, in trying to encourage the rest of the donor community to recognize the scale of the problem and to increase the amount of aid money that should be spent. They’ve also tried to frame that in terms of a comprehensive reform agenda which fits alongside oil security concerns. The British government took the lead in 2010 setting up the Friends of Yemen, which is a multilateral coordination mechanism to improve international engagement in Yemen.

Despite all of that, there’s still been an enormous resistance to the kind of reforms that DFID, the IMF, the World Bank – the kind of Western consensus around governance reforms in Yemen. It was in the context of thinking about that and thinking about the behaviour of the elite, why they weren’t on board, why they were behaving in the way that they were, looking at the kind of bigger picture question around the systemic problem that Yemen illustrates, that really led me to think that there is a question here about a discussion that’s going on in DFID about British aid policy and Britain’s international tax strategy, and the crucial role that Britain plays in this. And the fact that Cameron has taken this initiative this year and come out and starting to change the narrative and the discourse around tax – that does have an impact on aid. It does seem to me that it’s more of an internal strategic question, the relationship that DFID has to colleagues in the British government, how that discussion is taking place and how that frames the way that aid is perceived and carried out. I would really hope that people are able to read this report with those questions in mind.

John Christensen:
Thank you. So there we are, a coherence issue. A great discussion. I don’t think this discussion would have happened 10 years ago at this level. The issue has come right to the forefront – G8, G20. DFID has played a very interesting part in that, not least within the initiative of tax inspectors at our borders, which is a great initiative that came out of HMRC many years ago. I’d like you all to thank our speakers in the time-honoured fashion. Thank you very much indeed.